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ABSTRACT

Presents basic legal issues fundamental to revenue bonds (bonds secured by pledging only the revenues from the facility for the payment of the principal and interest on the bonds) authorized for construction of college and university residence halls and provides reference to, as well as discussion of, court decisions giving specific attention to precedent on the issue of default. Concludes that with leveling of enrollments and retrenchment, universities will face difficult decisions and perhaps even litigation regarding the issue of payment or nonpayment of revenue bonds for residence halls. (Author/PKP)

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TITLE: A LEGAL PERSPECTIVE ON REVENUE BONDS FOR RESIDENCE HALLS

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ABSTRACT: Authors discuss the basic legal issues fundamental to revenue bonds authorized for construction of residence halls. In addition, the authors provide reference to, as well as a discussion of, court decisions giving specific attention to precedent on the issue of default.

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A LEGAL PERSPECTIVE ON REVENUE BONDS FOR RESIDENCE HALLS

The purpose of this paper is to present the basic legal issues fundamental to revenue bonds authorized for construction of residence halls and to provide reference to, as well as a discussion of, court decisions giving specific attention to precedent on the issue of default. Although there are numerous types of bonds, this discussion will primarily be concerned with revenue bonds and not with the various types of general obligation bonds. For clarity and definitive understanding, general obligation bonds are secured with the full faith and credit of the state and constitute a debt of the state. However, revenue bonds are secured by pledging only the revenues from the facility for the payment of the principal and interest on the bonds. Fiscally, interest rates on revenue bonds are almost always higher than general obligation bonds because they have a greater element of risk (Alexander and Solomon, 1972). Revenue bonds are usually defined as those bonds, the debt service of which is payable solely from the revenues or earnings derived from the operation of a revenue producing enterprise or facility constructed or acquired with the proceeds of such bonds. The debt service of the bonds is payable solely out of the revenue pledged for such purposes and that the issuing body shall not be obligated to levy any taxes or make any appropriation from any source other than the revenues for the payment of the debt service (Chermak, 1954).

Fowler (1938) notes that revenue bonds have been issued for construction of facilities ranging from armories to sanitariums, from golf courses to stadiums and from parking garages to highways. The point is that revenue bonds could be justifiably issued for almost any type of revenue producing or project vital to a revenue producing, facility.

In this paper, an attempt will be made to focus specifically on revenue bonds issued for the construction of residence halls. Alexander and Solomon (1972) list three primary reasons for the attraction of college and university administrators to residence halls financed by revenue bonds: (1) The users pay for or amortize the bonds which is a good selling point to the public, (2) Revenue bonds are generally not included in state statutory debt limitations[1]. (3) Voter approval is not required [2] (Stollar, 1967). Additionally, the courts have also held that state legislative approval is not required[3]. These previously cited court cases document the conclusion that governing bodies of institutions of higher education, such as Boards of Trustees, have the singular power to issue revenue bonds. This holding is most explicitly stated in *Fanning v. University of Minnesota*, 236 N. W. 217, 183 Minn. 222 (1931). The courts have held that colleges and universities are distinct legal entities like corporations. Thus, the issuing of revenue bonds is a matter of management falling within the discretionary powers of the governing body. Some state laws, however, require institutions of higher education to have such revenue bonds issued through a state-wide agency or bonding authority.

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[1]*Application of Board of Regents of University of Oklahoma*, 161 P. 2d. 447, 195 Okl. 641 (1945); *Baker v. Carter*, 25 P. 2d. 747, 165 Okl. 116 (1933); *Barbour v. State Board of Education*, 13 P. 2d. 225, 92 Mont. 321 (1932); *Boe v. Foss*, 77 N. W. 2d. 1.; *Fanning v. University of Minnesota*, 183 Minn. 222, 236 N. W. 217 (1931); *Harmon v. Alabama College*, 177 So. 747, 235 Ala. 148 (1938); *Opinion of the Justices*, 93 So. 2d. 923 (Ala.); *State v. Board of Control*, 66 So. 2d. 209 (Fla.); *State v. Davis*, 229 N. W. 105, 59 N. D. 191 (1930); *State v. Regents of University System of Georgia*, 175 S. E. 567, 179 Ga. 210 (1934); *State College Development Association v. Nissen*, 281 N. W. 907, 66 S. D. 287 (1938); *State ex. rel. Curators of the University of Missouri v. McReynolds*, 345 Mo. 1199, 193 S. W. 2d. 611 (1946); *State ex. rel. Fatzer v. Board of Regents of State of Kansas*, 167 Kan. 587, 207 Pac. 2d. 373 (1949).

[2]*Wood v. Boise Junior College Dormitory Housing Commission*, 342 P. 2d. 700; *Jacobs v. Sharp*, 211 Ark. 865, 202 S. W. 2d. 964 (1947); *Baker v. Carter*, 25 P. 2d. 747, 165 Okl. 116 (1933).

[3]*Application of Board of Regents of University of Oklahoma*, 161 P. 2d. 447, 195 Okl. 641 (1945); *Boe v. Foss*, 77 N. W. 2d. 1.; *Fanning v. University of Minnesota*, 236 N. W. 217, 183 Minn. 222 (1931); *Hoyt v. Trustees of State Normal School*, 44 P. 2d. 513, 96 Colo. 442 (1935); *State College Development Association v. Nissen*, 281 N. W. 907, 66 S. D. 287 (1938); *State ex rel. Curators of the University of Missouri v. McReynolds*, 193 S. W. 2d. 611, 345 Mo. 1199 (1946).

Usually the bonds of state bonding authorities are technically not a debt of the state and therefore the state is not liable for such bonds. Moreover, state bonding authorities typically have no taxing power. The function of such agencies is purely administrative, without legislative or judicial perogatives (Fowler, 1938). The early recognition of this fact led to the creation of state authorities to administer such bonding questions. The idea was that a legally established state authority is likely to be in a better position to negotiate bond sales and thus insure optium interest rates (Johns and Morphet, 1975). When an authority has more than one project under its jurisdiction, the pledge of its full faith and credit would give the project financed a greater source of revenue. If the projects are all self-liquidating the risk of the loss of revenues is diffused and the resultant cost of borrowing may be reduced. Similarly, a municipality that pledges its full faith and credit toward the payment of the debt service of a revenue producing project will obtain a lower rate of interest on a bond issue secured by a pledge of the revenues of the facility financed. This double pledge reduces the risk of loss,thereby reducing the interest cost (Chermak, 1954).

Residence halls have been constructed and financed by revenue bonds secured by a variety of pledged revenues. Many trustees pledge solely the rentals of the facilities to be constructed [4] while others include income from other sources such as other residence halls[5], earnings of the press[6],

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[4] *Hoyt v. Trustees of State Normal School*, 96 Col. 442, 44 P. 2d. 513 (1935); *Baker v. Carter*, 165 Okla. 116, 25 P. 2d. 747 (1933); *McLain v. Regents of University*, 124 Ore. 629, 265 P. 412 (1928); *State ex rel. Kaufman v. Davis*, 59 N. D. 191, 229 N. W. 105 (1930); *State College Development Association v. Nissen*, 66 S. D. 287, 281 N. W. 907 (1938); *Hopkins v. Baldwin*, 123 Fla. 649, 167 So. 667 (1936); *State ex rel. Curators of University of Missouri v. McReynolds*, 354 Mo. 1185, 193 S. W. 2d. 611 (1946); *State ex rel. Fatzer v. Board of Regents of State of Kansas*, 167 Kan. 587, 207 P. 2d. 373 (1949); *Application of Board of Regents of Oklahoma College for Women*, 204 Okla. 385, 230 P. 2d. 453 (1951) (These citations are also from Chermak, 1954, p.104).

[5] *Barbour v. State Board of Education*, 92 Mont. 321, 13 P. 2d. 225 (1932); *contra: Wilder v. Murphy*, 56 N. D. 436, 218 N. W. 156 (1928) (These citations are also from Chermak, 1954, p. 104).

[6] *Fanning v. University of Minnesota*, 183 Minn. 222, 236 N. W. 217 (1930) (These citations are also from Chermak, 1954, p. 104).

and other fees [7] (Chermak, 1954). These latter two cases cited by Chermak (1954) indicate that there is precedent for both approving and disallowing revenue bonds for residence halls which pledge general or miscellaneous fees that may be charged to the student. It would appear, however, that the courts have generally held that revenue bonds for dormitories cannot pledge general fees. [8]

To this point we have discussed revenue bonds sold for the construction of residence halls, whether issued by the state or federal government. Also, we have noted that agreements authorizing the sale of these bonds may pledge funds from one or more sources. This cursory review is certainly not exhaustive. One can easily conclude that the resultant agreements for the issuing and sale of revenue bonds as well as for the pledging of monies to repay the revenue bonds, are numerous.

A review of two hypothetical but prototypic residence hall projects, one financed through revenue bonds issued by the federal government and one financed by revenue bonds issued by a state bonding authority, would aid in understanding. First, attention is given to a residence hall financed by revenue bonds issued by the federal government. In this case, the exact revenues pledged toward the security of the bonds will be specifically noted in the "agreement". A typical statement might stipulate, "the security of the bonds is the special obligation of the borrower (university) secured by a first lien on a pledge of the net revenues to be derived from the operation of the only other currently existing girls

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[7] *State v. Board of Regents*, 179 Ga. 210, 175 S. E. 567 (1934); *contra*: *Harmon v. Alabama College*, 235 Ala. 97, 177 So. 747 (1937); Note, 6 Geo. Wash. L. Rev. 387 (1938) (These citations are also from Chermak, 1954, p. 104).

[8] *Application of Board of Regents of University of Oklahoma*, 171 P. 2d. 597 Okla. 327.

dormitory". In the associated "terms and conditions" it will usually be noted that the university agrees to maintain reasonable reserves and parietal rules (residency requirements) to guarantee the payment of the bonds. The exact wording might read, "the borrower (university) shall establish and maintain throughout the life of the loan, such parietal rules, rental rates and charges for the use of the project facilities (residence hall) and other such facilities the revenues of which are pledged in this 'agreement' as may be necessary to pay the debt service on the bonds".

It is interesting to note that many colleges and universities have become parties to such bonding agreements which include stipulations for mandatory imposition of parietal rules if necessary to meet the financial obligations of bonded indebtedness. Recent court decisions have held that the imposition of such rules solely for the purpose of raising occupancy so as to meet financial obligations is in violation of the equal protection guaranteed by the Fourteenth Amendment of the United States Constitution.[9] In essence, colleges and universities that become parties to such agreements, become parties to contracts which have stipulations that are legally unenforceable.

Recent court cases, however, have held that parietal regulations are constitutional if they are based, at least in part, on the fact that some educational benefits can be derived from such residence.[10] While the courts have asked for data to substantiate the claim of "educational benefits", those institutions engaged in litigation have not found the gathering of such data a difficult task. Additionally, most courts have refused to involve themselves in the process of distinguishing between the primary

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[9] *Cooper v. Nix*, 343 F. Supp. 1101 (1972); *Moltere v. Southeastern Louisiana College*, 304 F. Supp. 826 (1969).

[10] *Prostrollo v. University of South Dakota*, 507 F. 2d. 775 (1974); *Schick v. Kent State University*, United States District Court, N. D. Ohio E. D. (1975), Case no. C74-646; *Poynter v. Drevdahl*, 359 F. Supp. 1137 (1972); *Pratz v. Louisiana Polytechnic Institute*, 316 F. Supp. 872 (1970), affirmed, 915 ct. 1252 (1971).

and secondary purposes of implementing such regulations. They have generally ruled that justification for imposing parietal rules exists if "educational benefits" are among the multiple purposes upon which the implementation is based. [11]

Next, attention is given to a residence hall financed by revenue bonds issued by a state bonding authority. The "agreement" entered into for the construction of this residence hall will probably specifically stipulate, "the trustees will fix, maintain, adjust and collect 'fees and charges' in order that the monies derived therefrom will be sufficient at all times to provide funds for the payment of the bonds". Earlier in the document, "fees and charges" would usually be defined as "all fees, rentals and other charges imposed by the university upon students, faculty members and others using or being served by, or having the right to be served by the projects (financed by the state bonding authority) of the university; matriculation, hospital, laboratory, athletic, admission and other fees from students, faculty members and others matriculated, attending or employed at the university, and fees, rentals and other charges from students, faculty members and others using or being served by existing buildings, stadia and other structures at the university". If these monies were not sufficient, then income from all state bonding authority projects would be pledged. Although such bonds are not a debt of the state, they do have the full faith and credit of the state bonding authority.

For discussion purposes, let's now assume that enrollment is declining, the university residence halls are not full, and the university is in financial straights. In the former example, where revenue bonds were financed

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[11] *Prostrollo v. University of South Dakota*, 507 F. 2d. 775 (1974); *Schick v. Kent State University*, United States District Court, N. D. Ohio E. D. (1975), Case no. C74-646; *Poynter v. Drevdahl*, 359 F. Supp. 1137 (1972); *Pratz v. Louisiana Polytechnic Institute*, 316 F. Supp. 872 (1970), affirmed, 915 ct. 1252 (1971); *Moliere v. Southeastern Louisiana College*, 304 F. Supp. 826 (1969).

through the federal government, default could occur without detriment to the federal or state government or even to the university, since the full faith and credit of these institutions were not pledged as security for the debt. Should the university not be able to meet the financial obligations regarding the bonded indebtedness of the facility, then the bondholders could request the courts to issue a *writ of mandamus* in order to remedy this situation. Such a *writ of mandamus* would obligate the university to impose rental increases or parietal rules sufficient to meet the financial obligations of the university. Assuming these remedies had already been exhausted, theoretically, the bondholders would experience a loss on their investment. Although neither the university nor the state is obligated for the payment of these bonds, it is generally deemed appropriate to make sure these bonds are paid. Such a default could, and most probably would, destroy the credit rating of both the institution and the state. The tacit assumption underlying such a *modus operandi* is that the university and/or the state may want to borrow monies in the form of bonds again at some point in the future.

With these same assumptions in the latter example, where revenue bonds were financed by a state bonding authority, it would be almost impossible to default on the bonds unless a total collapse of university and state funding of the university seemed eminent. Even in this extreme case, the bonds still could be paid in order to maintain the bondholders confidence in "the system".

Litigation specifically focusing on default or potential default of residence hall bonds is minimal. Precedent is considered to be established by the one case now on record. Due to the lack of case law in this specific area, reference to the *Davis v. Moon* case heard by the Idaho Supreme Court in 1955 is extensive. The 31st Legislature (Idaho), made no appropriation for the operation of Northern Idaho College of Education. The college, due to

lack of funds, ceased operating from the summer of 1951 until fall of 1955. During that time no revenue was derived from the residence hall constructed from the proceeds of the bond issue. This agreement was similar in pledged securities to the typical residence hall financed by revenue bonds by the federal government discussed earlier. The 33rd Legislature enacted a law to pay for the bonds subject to default. It was specifically noted that the bonds were not a debt of the state; however, it was also noted that the default occurred because the state failed to fund the university. This rationale, coupled with the desire to protect the "credit of this and other institutions of higher learning in this State of Idaho", provided sufficient justification for the state to pay the bonds. [12]

Justice Keeton dissented from the majority opinion, quoting the original bonding agreement that "such bonds shall not constitute a debt, legal or moral of the state of Idaho, shall so recite on their face, and shall not be enforceable against the state, nor shall payment thereof be enforceable out of any funds of the institution issuing said bonds other than the income and revenues pledged and assigned to, or in trust for the benefit of, the holder or holders of such bonds". [13]

He further notes that in accordance with that agreement the bonds were sold on the market and now the holders of the defaulted bonds ask the state to bail them out. He stated that it seemed plain and apparent that the legislature converted a debt owed to individuals by an educational institution of the state into a state obligation, "which debt or obligation never existed or could exist". He continues, "the State thus acquiring such defaulted bonds

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[12] *Davis v. Moon*, 289 P. 2d. 614. (Idaho).

[13] *Ibid.*

must of necessity have entered into the bond buying business, which is not a function of State government. The Act in question being constitutional, as held by the majority, I can visualize continual raids on the State Treasury. Pressure groups and propaganda committees can advance logical arguments for similar future Acts, relieving most anybody from poor investments made on the credit of some State Institution". [14]

A more recent example of potential default, Northwestern Oklahoma State University, received national attention in The Chronical of Higher Education. Reserve funds at this institution have been heavily utilized and will certainly be depleted by mid-year of 1978. At that time a crises will be unavoidable for this institution. A decision concerning the payment or non-payment of the revenue bonds must be made by the trustees or perhaps even by the state. Another recent example also is found in Oklahoma; According to the National On-Campus Report, Northeastern Oklahoma State University recently raised student fees to hold off default on residence hall bonds. It could reasonably be inferred that some means will be found to pay the bondholders in order to prevent default at these institutions. Although not a certainty, precedent would suggest a high probability of such an occurance.

In conclusion, most residence halls in this country have been financed by revenue bonds. Residence halls are considered self-liquidating facilities, and all costs are passed directly on to the students. Good management is the key to insuring that financial obligations including bond retirement are met. Theoretically, default on the bonds could take place without detriment to either the state or federal government as these governments are in no way obligated by the bonds. This is legally an acceptable alternative. However,

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[14] Ibid.

as we have seen, default is considered a politically and financially unacceptable alternative and a last resort. The respective state and/or the federal government may be inclined to pay rather than to allow default to occur.

As the financial "belt-tightening" in higher education continues, and with the leveling of enrollment, many college and university administrators may be facing litigation or at least some difficult decisions in the near future. The issue of meeting the bonded indebtedness of residence halls will be an emerging area of litigation and the resolution of this complex issue will be difficult. This initial legal perspective on revenue bonds for residence halls is necessary for those administrators responsible for fiscal and/or residence hall management.

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